Supreme Court, U.S.
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No. 93-2031

IN THE
SUPREME COURT OF THE UNITED STATES
October Term, 1993

TOM MISTICK & SONS, INC.,

Petitioner

v.

COMMONWEALTH OF PENNSYLVANIA,

Respondent

Petition For A Writ Of Certiorari
To the Supreme Court of Pennsylvania

BRIEF IN OPPOSITION TO THE PETITION FOR A WRIT OF CERTIORARI

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COUNTERSTATEMENT OF THE QUESTION PRESENTED

Does Pennsylvania's refusal to allow federal S corporations a state tax deduction for hypothetical federal income taxes which they do not pay and are not subject to represent a violation of the Equal Protection Clause?

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STATUTES

Sections 1361-1366 of the Internal Revenue Code,

26 U.S.C. §1361.....1, 6, 7
26 U.S.C. §1361(b)..... 6
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Subchapter C of the Internal Revenue Code, 26 U.S.C. §301 et seq. 1

Pa. Stat. An. Title 72, §7601(a) (Purdon 1990) 5, 7

COUNTERSTATEMENT OF THE CASE

Petitioner, Tom Mistick & Sons, Inc., elected federal S corporation status with the Internal Revenue Service and this election was effective for the tax years in issue. (R. p. 48a). As an S corporation, Petitioner is not subject to and does not pay federal income tax. Instead the shareholders report their proportionate share of the S corporations' taxable income on their individual federal income tax returns. 26 U.S.C. §1361, et seq. This income is then treated as the personal income of the shareholder.

Corporations which do not or cannot elect S corporation status are taxed under Subchapter C of the Internal Revenue Code, 26 U.S.C. 301, et seq., and are referred to as C corporations. C Corporations are subject to and do pay federal income tax when this liability arises.

Both S and C corporations are subject to a Pennsylvania tax on their value, known as the capital stock tax. Value for capital stock tax purposes is computed under a statutory formula which considers the net income of the corporation. C corporations deduct federal income taxes paid in arriving at net income, but S corporations, which are not subject to and do not pay federal income taxes, are denied such a deduction by Pennsylvania tax regulations.

Petitioner now challenges the constitutional validity of the Pennsylvania rule which does not allow S corporations a deduction for a tax they did not pay. While both C and S corporations are subject to capital stock tax at the same tax rate, the difference

in treatment for calculating net income reflects the very real economic difference between the two types of entities. (R.p. 52a.)

SUMMARY OF ARGUMENT

A rule prohibiting a deduction with respect to a tax to which the taxpayer is not subject and does not pay is facially rational. By wholly voluntary elections, corporations choosing S corporation status avoid the federal income tax. The Pennsylvania rule disallowing a deduction for the hypothetical tax such corporations would have paid in the absence of the election does not violate the Equal Protection Clause. No substantial federal question has been raised in the petition for writ of certiorari and said petition should be denied.

ARGUMENT

I. PENNSYLVANIA'S CAPITAL STOCK TAX PROVISIONS AND THEIR APPLICATION TO S CORPORATIONS

This Petition involves the constitutional validity of the valuation provisions of the Pennsylvania capital stock tax, specifically its application to S corporations under Federal income tax law. The Pennsylvania capital stock tax is a tax on the value of a corporation, calculated in accordance with the statutory formula. Pa. Stat. An. Title 72, §7601(a)(Purdon 1990). This formula relies on both net worth and net income (or average net income) in determining the corporation's value. The net worth aspect of the computation is not at issue; the net income component, specifically its application to S corporations, is the issue in this case.

An S corporation is defined by Section 1361 of the Internal Revenue Code, 26 U.S.C. §1361. In order to qualify as an S corporation, the corporation cannot have more than 35 shareholders, may not have another corporation as a shareholder, and may not have more than one class of stock. 26 U.S.C. §1361(b). Most important, a corporation must affirmatively elect S corporation status with the Internal Revenue Service, and all shareholders must consent to this election. 26 U.S.C. §1362(a). The general rule is that S corporations are not subject to and do not pay federal income tax. 26 U.S.C. §1363(a). Instead, the shareholders report their proportionate share of the S corporation's income as taxable income on their individual federal income tax returns. 26 U.S.C. §1366. A corporation may

prospectively elect out of S corporation status if the shareholders holding more than one-half of the shares of the stock of the corporation consent to the revocation of the S corporation election 26 U.S.C. §1362(d).

For purposes of Pennsylvania's capital stock tax, the definition of net income per books is contained in the definition of "average net income" which is found in Section 601(a) of the Tax Reform Code, Pa. Stat. An., Title 72, §7601(a). Pursuant to its authority, the Pennsylvania Department of Revenue has promulgated a regulation, 61 Pa. Code §155.26, interpreting the statutory definition of average net income for purposes of calculating the value of a corporation's stock. This regulation contains the following provision which is central to this appeal:

> No adjustment to net income or loss may be made for Federal income tax which would have been paid by a corporation electing S corporation treatment under Section 1361 of the IRC (26 U.S.C.A. §1361) or for Commonwealth Corporate Net Income Tax which would have been paid by a corporation electing Pennsylvania S corporation treatment under Article III of the T.R.C. (72 P.S. §7301-7361) or for Commonwealth personal income tax paid by the shareholders of the corporation.

61 Pa. Code §155.26(g).

As a matter of Pennsylvania law, the Pennsylvania Supreme Court has decided that this regulation is a proper interpretation of the statutory definition of net income for capital stock valuation purposes. Tool Sales & Service Co., Inc., v. Commonwealth, _____ Pa. _____, 637 A.2d

607 (1993). Consequently, under Pennsylvania law, S corporations subject to the capital stock tax cannot deduct the federal income tax they would have paid or would be liable for if they had not chosen to operate as S corporations under Federal income tax law.

II. PENNSYLVANIA'S TREATMENT OF S CORPORATIONS IS CONSTITUTIONAL

Pennsylvania's rule prohibiting S corporations from deducting a hypothetical income tax (to which they are not subject and which they do not pay) in arriving at their net income for capital stock valuation purposes is rational and reasonable, and does not violate the Equal Protection Clause of the United States Constitution.

Petitioner voluntarily elected S corporation status. It now claims that

the Equal Protection Clause guarantees it the right to claim a hypothetical deduction without actually incurring the corresponding tax liability.[1] Clearly, a rule which does not permit the deduction of a hypothetical tax is a rational law.

This Court set forth the standard for equal protection challenges to tax laws in Nordlinger v. Hahn, 505 U.S. _____, 120 L.Ed 2d 1, 13, 112 S.Ct. 2326, _____ (1992).

> In general, the Equal Protection Clause is satisfied so long as there is a plausible policy reason for the classification, the legislative facts on which the classifi-

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[1]It is undisputed that the shareholders of the S corporation must report the earnings of the corporation on their individual federal tax returns and pay tax thereon. This is not relevant, however, because the Pennsylvania law in question governs the valuation of the corporate entity, not the valuation of any of the shareholders.

> cation is apparently based rationally may have been considered to be true by the governmental decision maker, and the relationship of the classification to its goal is not so attenuated as to render the distinction arbitrary or irrational. This standard is especially deferential in the context of classifications made by complex tax laws. "[I]n structuring internal taxation schemes, `the States have large leeway in making classifications and drawing lines which in their judgment produce reasonable systems of taxation." (Citations omitted)

The Pennsylvania regulation sets forth a rule which distinguishes between corporations which are subject to the federal income tax and corporations which are not subject to the federal income tax. This represents a reasonable determination

that corporate entities which are not subject to and do not pay federal income tax have, all other things being equal, a higher value than corporations which are subject to and do pay the federal income tax. S corporations and C corporations are not similarly situated and the Pennsylvania law rationally reflects this distinction.

Petitioner challenges a law that rationally distinguishes between different classes of corporate taxpayers, those which elect S corporation treatment and corporations which are C corporations. "The Equal Protection Clause `applies only to taxation which in fact bears unequally on persons or property of the same class'". Allegheny Pittsburgh Coal Company v. County Commissioner of Webster County, 488 U.S. 336, 343, 102 L.Ed 2d 688, 1095 Ct. 633 (1989), citing

Charleston Fed. Savings & Loan Assn. v. Alderson, 324 U.S. 182, 190, 89 L.Ed. 2d 857, 65 S. Ct. 624 (1945). S corporations and C corporations are unequivocally different in their treatment under the Federal income tax laws and this treatment affects their economic value. Pennsylvania's law which incorporates this difference is based on a "plausible policy reason".

CONCLUSION

For the reasons stated, the Commonwealth of Pennsylvania respectfully submits that the petition for writ of certiorari presents no substantial federal question, and that the distinction drawn by the challenged Pennsylvania law is reasonable, rational and well within the confines of the Equal Protection Clause. On these grounds, the petition for writ of certiorari should be denied.

Respectfully submitted,

ERNEST D. PREATE, JR.
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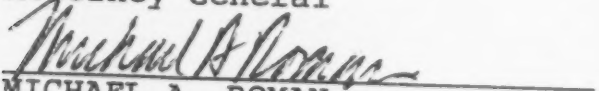
By: 

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